

## The Uncomfortable Consequences of a Universal Multi-Lateral Interchange Fee (MIF) for Europe

**Retailers and European officials see a single universal MIF as a logical corollary of the borderless EU concept. But the consequences will be uncomfortable unless MIF rates are allowed to converge over a lengthy period.**

By any standards, payment cards are big business in the 25 nation EU with over 500m debit and credit cards issued, annual transaction volumes of 23 bn and total turnover exceeding €1,400 bn. Commissions charged by banks to merchants for card acceptance exceed €13 bn, with the interchange component (or MIF) generating over €8 bn annual revenue for payment card issuers.

Across the EU, debit card issuance has been highly successful with rapid growth in usage (over 23% per annum during 1998-2002), while credit card issuance continues to grow steadily. Cash is rapidly being displaced and cheques are obsolete, except in France and the UK. Use of debit and credit cards now outstrips all other forms of cashless payment.

From a banker's perspective, the payment card commercial model has been highly successful. Merchant Service Charge (MSCs) generate profits for acquirers, encouraging investment and growth of Europe's EftPos network. MIFs encourage issuer banks to invest in new products and to stimulate cardholder usage, which in turn generates MSC revenues for acquirers, a truly virtuous circle. (See Box 1 below for further explanation of revenue and cost flows.)

### **Box 1 - What is Multi-Lateral Interchange (MIF)?**

- Merchant acquiring banks charge merchants a Merchant Service Charge (MSC) for card acceptance. Within the EU charges are typically "ad valorem" for credit and for debit a mixture of "unit" and ad valorem.
- MSCs divide into two components. First, a charge for the acquiring service, which is a revenue stream to the merchant acquiring bank. This fee covers marketing, selling, support, acquirer risk (fraud, chargebacks, bankruptcy), transaction processing and in several countries all (or a proportion) of terminal supply, telecoms and terminal consumables.
- The second component is interchange or MIF, paid away by the merchant acquiring bank to the card issuer. This is an interbank cost to cover, the payments guarantee (ie. the issuer's guarantee of transaction settlement), chargeback and consumer protection risk, transaction processing and (for credit only) the cost of funds for the "free of interest" period.
- Typically the MIF component represents between 65% - 80% of the MSC.

But not everyone is happy. It is now over 13 years since the European Commission (EC) outlined its vision for payments in Europe. In the early 1990s the EC claimed that without an open and efficient payments market the EU would be constrained, capital flows restricted and Citizen Europe poorly served.

Gradually this vision is being implemented. Measures like the euro, the ECB and Target have all been vital components in building the pan-European payments framework.

However, within the payment card sector the vision of a common, EU wide commercial framework for card acceptance has been long in the coming. Europe's banking associations (including the European Payments Council – EPC) have avoided responsibility for implementing the concept, while Visa and MasterCard have been unable to move beyond setting default MIFs.

In the late 1990s, changes began to emerge. Europe's merchants, under the collective framework of EuroCommerce, complained to the EC Competition Directorate that the Visa MIF applied to intra-European transactions, was anti-competitive.

After protracted discussions, Visa EU agreed to reduce intra-EU credit card rates to 0.7% and debit card rates by 20% by 2007 while the EC appeared to accept the principle of the four party payments model.

This was the beginning of increased regulatory activity within the EU, with the agreement by both Visa and MasterCard to publish their intra-European rates and provide the basis on which their MIF is calculated.

Around the world domestic regulators have become increasingly interventionist, particularly in Anglo Saxon countries. The Reserve Bank of Australia has almost halved domestic MIFs. The authorities in the US have also been active, with the 'Wal-Mart' and other cases driving change.

In the UK, MasterCard's domestic MIF is under investigation by the OFT. Many predict the UK credit card interchange of 1.0% is set to fall by 50% or more. In mainland Europe, regulators are also active, with Interpay in the Netherlands (and its owner banks) penalised for alleged overcharging and market dominance practices over the past four years.

Merchants continue to complain, particularly given the existence of the eurozone) that there is no justification for the different MSC rates and the variety of charging formulae used in each EU nation when the underlying payment service is the same everywhere at least for big merchants with their own POS equipment. Similar complaints arise over the lack of transparency in calculating domestic MIFs.

Increased regulatory interest in interchange, linked with the drive to create a payments market sans frontieres, has sparked suggestions that the underlying goal is to develop a common MIF, applied across the EU in place of existing domestic arrangements. Some in the banking and payments industry believe this to be the inevitable next step.

By any standard, the EU domestic card schemes have adopted a haphazard and idiosyncratic approach to the assessment and implementation of MIFs. In contrast, Visa and MasterCard have developed a relatively structured calculation framework.

The schemes employ independent consultants to collect costs and develop models following a standard methodology and process. Participating members complete detailed issuer and acquirer cost surveys. The MIF output is produced to a consistent formula and in several nations is submitted to regulators for approval.

No such common process applies to mainland Europe's debit card schemes, many of which were originally founded on ATM cash withdrawal brands. In these cases, the ATM brand was often extended to encompass POS transactions with little distinction between the ATM commercial framework, the debit card scheme, and card processing operational regulations.

As a result, many schemes were established without interchange and still operate this way today (see Table 1 for summary). Those without debit interchange include Belgium, Denmark, Finland, Germany and the Netherlands.

Portugal and Spain operate a uniquely Iberian implementation of the interchange model, which enabled cheques to be bypassed and the rapid growth of EftPos terminal provision and current accounts through cross subsidies. France, under Groupement des Cartes Bancaire, has a split MIF with a core cost and a retrospectively calculated premium for fraud.

Country	Debit Scheme Name	Average MSCs <sup>1</sup> In 2004		Debit MIF Structure	Comments
		Credit	Debit		
Austria	Banomat/ Maestro	2.40%	1.14%	ad valorem	MSCs include allowance for minimum fee
Belgium	Bancontact	1.61%	€0.09 (approx)	None	Three party model for debit
Denmark	Dankort	0.95%	0.05	None	
Finland	Pankkikortti	1.20%	€0.08	None	Estimated debit MSC
France	CB	0.7%	0.7%	ad valorem	Includes inter/intra
Germany	ec-karte + POZ	1.72%	0.242%	None	Debit MSC excludes ELV volumes
Greece	Electron/ Maestro	2.50%	2.00%	ad valorem	
Ireland	Laser	1.86%	€0.18	Unit	
Italy	Bancomat	1.65%	0.67%	ad valorem	
Netherlands	PIN	1.60%	€0.06	None	
Poland	Electron Maestro	2.10%	2.10%	ad valorem	MSC includes high proportion of terminal provision
Portugal	Multibanco	2.86%	1.42%	ad valorem	MSC includes some terminal provision
Spain	4B, CECA, ServiRed	1.67%	1.67%	ad valorem	MSC includes all terminal provision
UK	Switch/Visa	1.60%	€0.16	Unit	

<sup>1</sup> Domestic rates - exclude inter/intra blending except for France

**Table 1 Summary of EU MSC and Interchange Structures (all figures approximate)**

In addition, each domestic scheme developed commercial frameworks for acquiring which reflect local market requirements. In the process, those which set a MIF also made mistakes, misunderstanding the risks and complexities of changing long standing agreements.

In the UK, the Switch scheme was launched with no interchange. The result was zero revenue to fund the payments guarantee and zero incentive for card issuers to join. Switch therefore had the unfortunate and difficult task of introducing a positive interchange in the early 1990s. Within a year MSCs for Switch fees almost doubled, with the inevitable strong merchant resistance to charges.

In the early 1990s in Portugal, where no interchange existed, the introduction of an interbank fee for Multibanco debit prompted a one day national boycott of debit cards, rapidly leading to the demise of directly issued Multibanco debit cards.

In Denmark, banks attempted to charge for debit, and in an over hasty reaction to merchant protests, the Danish Government regulated. Dankort debit has had neither interchange nor MSCs for the past 19 years and Danish domestic credit card MSCs have been capped at 0.75% (note both regulations are predicted to change in 2005 with the implementation of the 'Dankort Act').

In Belgium, Banksys's merchant fee has now been regulated for over 15 years. Similarly in Germany, ec-Karte is based on a unique three party model with no acquirer entity and no interchange. Some claim this unusual and unprofitable structure has been responsible for the slow growth of online debit in Germany.

Card issuers' rationale for the MIF has also developed on a country by country basis as well. In many, debit card interchange has subsidised the current account and enabled free or low cost banking to Citizen Europe. Across mainland Europe interchange has also sustained the credit card product during its protracted and very slow growth.

To summarise, there are differing approaches and different commercial models in most countries. So, at face value, a case can be made for a common acceptance framework for payment cards. Many would argue that at the heart of any new structure should be a common EU-wide MIF for all payment cards.

What would be the consequences should a universal MIF be applied? Payment Systems Europe (PSEL) have developed a forecast model for the EU cards market which in statistical terms describes the payment card structure in each nation.

Using this data, PSEL developed a **"Common MIF Impacts Model"** to calculate the impact on each nation of a common MIF for both debit and credit cards. As a benchmark PSEL selected the UK as a model market with some of the most competitive debit and credit card terms. The objective was to understand the consequences of applying an Anglo Saxon model on the rest of the EU. Further details on the assumptions on which the model has been constructed, together with an analysis of the results, is provided within **Appendix 1**.

So what can we conclude from this review? Clearly introducing a common MIF could have a significant impact on merchants, banks and cardholders. The change could lead to a radical restructuring of the merchant acceptance terms for credit and debit cards and the basis on which cardholders are charged for issuer services.

Can a common MIF based on the Anglo Saxon model be implemented for all 25 EU countries? The general conclusion must be that this would be a high risk strategy for the regulators. As the analysis shows each EU country is at a different stage of development for both debit and credit card products.

All have different levels of efficiency, different costs and practices. Domestic MSC rates and MIFs have been constructed (or avoided) over many years. A radical change would alter dynamics of some acquiring businesses and slow down the expansion of the EU wide acceptance network.

For several countries, debit card MSCs would be introduced for the first time, causing great concern amongst the merchant population who would have higher costs to absorb. For example, merchants in Denmark would have to pay over €1,000 extra per POS per annum under a MIF of €0.08.

The major loser will be France and Portugal, where MSC and MIF revenues would fall considerably, impacting both issuers and acquirers. French and Portuguese issuers stand to lose about €30 per current account per annum. The impact on the French payment card business would be so great that the very basis of the CB concept would need to be revisited. A reduced debit MIF will also impact current account profitability in Austria, Italy, Portugal, Spain and Poland. Inevitably consumers will pay more in the form of substantially increased bank charges.

The major beneficiaries from falling credit card MSCs would be merchants, but this would be short lived. In many cases, acquirers would be forced to unbundle, raising charges (up to €2,200 per POS in Portugal) for services currently provided free of charge. Lower credit card MSCs will particularly impact the UK, Spain, Portugal and Poland. Merchant surcharging could also increase.

Credit card issuers in all countries would be impacted and would have to either cut annual costs per account by between €20 to €30, or radically increase revenues. Most mainland credit card issuers would find this impossible to achieve given the low revolving component in their revenues. Similarly, the business case to launch revolving products would be severely damaged and the benefits of spontaneous credit at the POS would gradually be withdrawn. Countries with developing credit card operations would be hit hardest, for interchange is the bedrock revenue until a critical mass of cardholders is achieved.

Whether a uniform MIF initiative would benefit Citizen Europe, or contribute towards the development of borderless intra-regional payments, with common acceptance rules, remains to be seen.

In mainland Europe, merchant savings from lower credit card MSCs are unlikely to impact the price of goods and services, given that debit predominates at the POS. In any event savings could be offset by higher prices for acquiring services.

Debit savings would be significant only in France, but would they be passed on to French citizens? Experience suggests that where MSCs have been reduced, the merchant has retained the benefit with no advantage to the consumer.

The conclusion must be that it is too early to introduce a common EU-wide MIF. Setting rates which reflect a low fee Anglo Saxon model would be highly premature and potentially could destabilise Europe's payments business. Perhaps the case for

standardisation is an illusion, for if 95% of all payment transactions (not just plastic) are internal to a country, domestic factors will act as the primary driver for change.

So the message to the EC, the international card schemes, the ECB and the EPC is to be patient. These bodies should adopt a more sophisticated and pragmatic approach. The quest for standardisation could trigger the law of unintended consequences which could cause havoc across the EU.

Several further years of convergence are needed before such a complex and high risk plan can be launched. In the interim local regulators, who are more sensitive to their local markets, are likely to be more successful in optimising the local card acceptance framework using their more devolved powers under the EC competition network. The EC can also supplement with a centralised EU-wide effort to encourage competition, to remove barriers to entry and set a target for convergence of seven to ten years.

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## Appendix 1

### Common MIF Impacts Model Assumptions and Analysis of Output

The purpose of this Appendix is to provide a summary analysis of the common MIF impacts modelling exercise. Table 1.1 summaries the assumptions on which the model has been constructed.

#### Common MIF Impacts Model Assumptions

- PSEL selected a sample five year period (2001 – 2005) to calculate for each country (see Table 1 for countries modelled) the values of domestic MSC revenues and MIF costs paid.
- The model calculates the impact of introducing a common MIF on current MIF flows and on MSCs. For the first model flex, we assumed a 0.5% ad valorem fee for credit cards and €0.08 for debit. This flex also assumed all countries move to unit charging for debit (with ad valorem fees disappearing).
- For the second flex, we assumed the implementation of a composite, single ad valorem MIF for both debit and credit of 0.35% of value. Under this flex, we assumed all countries would move to ad valorem charging for both card types.
- For both flexes, we assumed that credit card MSCs would hold at 1% assuming an average charge of 50 basis points for profitable acquirer service provision. For debit, we assumed that typical unit MSCs (which include a common MIF) would add between €0.08 - €0.12 as the acquiring fee.

**Table 1.1 MIF Model Assumptions**

First the impact on debit cards. As Table 1.2 indicates, a worrying picture emerges for debit cards under an MIF of €0.08. Total reductions in MSCs are over €11 bn over five years. The major loser will be France, where MSC revenues would fall radically, impacting issuers and acquirers. French revenues will fall by €6.5 bn assuming debit MSCs fall from 0.7% to €0.20.

Countries	Debit Cards with €0.08 MIF		Debit Cards with Common 0.35% MIF	
	€m Impact MSCs	€m Impact MIF	€m Impact MSCs	€m Impact MIF
Austria	(428)	(139)	(185)	(51)
Belgium	212	212	432	461
Denmark	149	209	368	428
Finland	151	151	255	255
France	(6,479)	(4,223)	(2,222)	(2,222)
Germany <sup>1</sup>	(65)	241	966	966
Greece	(19)	(16)	(13)	(13)
Ireland	7	10	46	55
Italy	(1,612)	(759)	(40)	(40)
Netherlands	452	452	911	933
Poland	(299)	(216)	(226)	(199)
Portugal	(1,315)	(1,115)	(969)	(969)
Spain	(1,830)	(1,467)	(1,275)	(1,275)
UK	0	2	1,881	2,265
<b>Total</b>	<b>(11,074)</b>	<b>(6,657)</b>	<b>(71)</b>	<b>596</b>

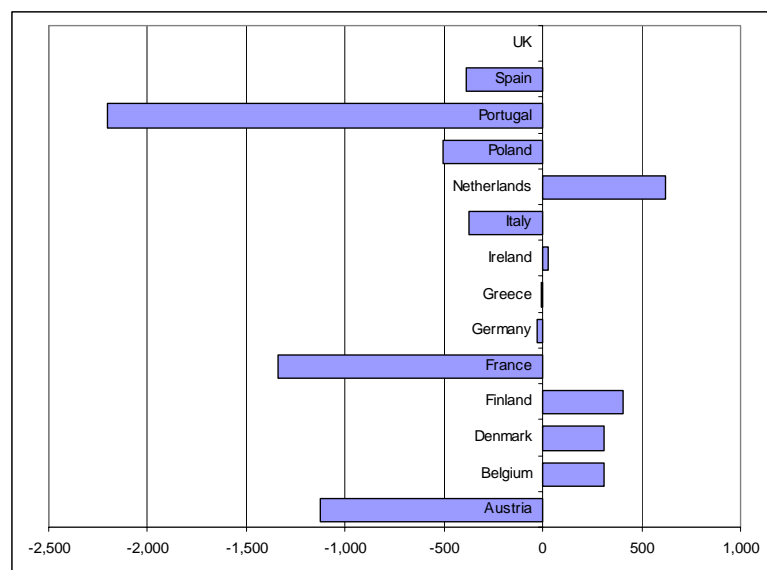
( ) = decline

<sup>1</sup> excludes ELV volumes

**Table 1.2 Five Year Impact on Debit Card MSCs of €0.08 / 0.35% Common MIF (all figures approximate)**

Table 1.3 indicates the five year increase and decrease in revenue per POS terminal under a unit MIF of €0.08. In Portugal, merchants would see annual MSCs per terminal fall by over €2,000. There would be similar, but lower, reductions in France, Austria and Poland.

A reverse situation would occur in the Netherlands, where merchants would receive over €600 extra in MSCs per terminal per annum. Smaller increases would apply in Finland, Belgium and Denmark.

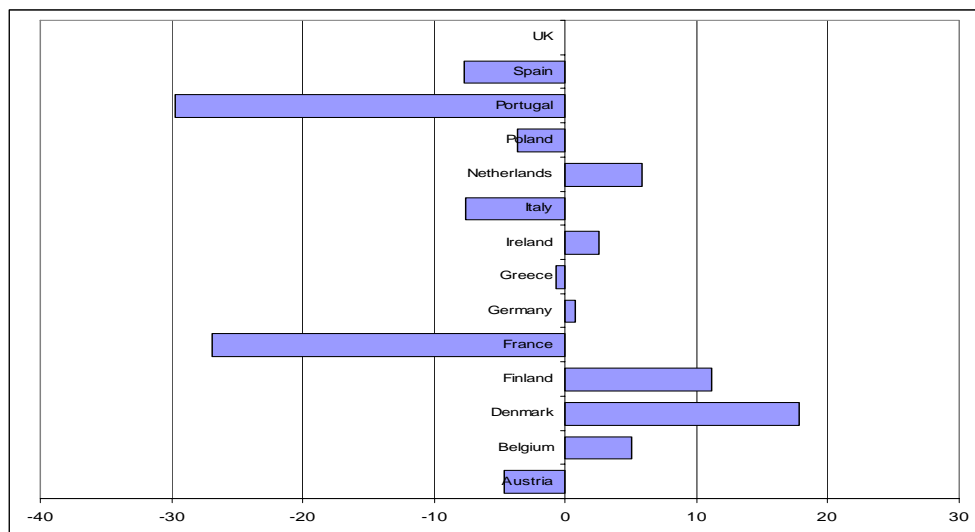


**Table 1.3 Average Change in Debit Card MSC per Merchant POS Terminal at €0.08 MIF in €**

Surprisingly, a common ad valorem MIF of 0.35% for debit shows a modest reduction in MSC revenues to banks of €71m. However, there would be substantial increases in Belgium, Denmark, Finland, Germany, Netherlands and the UK. The major loser would again be Portugal, but with a loss of MSC per POS terminal of €1623 per annum.

There would be winners and losers in card issuing as well if debit MIF moved to a unit rate (see Table 1.4). Portugal and France would face the largest shock, with a reduction in debit cardholder revenues of about €30 per account per annum at a time when card fees are under pressure. Austria, Italy, Poland and Spain would also have to consider raising card fees by €5 to €10 per annum.

Winners would be Denmark, with average new revenues of almost €20 per cardholder, followed by Finland, the Netherlands and Belgium. A composite rate of 0.35% would further drive up issuer revenues in seven countries (Belgium, Denmark, Finland, Germany, Ireland, Netherlands and the UK). Denmark would win with over €35 additional revenue per cardholder per annum.



**Table 1.4 Average Change Debit Card Interchange Cost per Active Card at €0.08 MIF in €**

Second, the impact on credit cards. Table 1.5 provides a summary of the two MIF options. A MIF of 0.5% would reduce credit card MSC incomes by €11 bn over five years. Clearly, the major beneficiaries would be Europe's merchants with an annual MSC saving per POS device of almost €434.

Around 83% of the value of reductions would occur in the UK, Spain, Italy and Germany. The UK alone would account for over 50% of the decline. A composite MIF of 0.5% produces even greater reductions for acquirers and benefits for merchants of around €550 in MSC per POS terminal per annum.

Lower credit card MSCs will particularly impact the UK, Spain, Portugal and Germany. In some regions (Iberia) this could lead to the unbundling of charges with fees raised for network and terminal provision, potentially an extra charge of €1,700 per POS per annum.

Countries	Credit Cards with 0.5% MIF		Credit Cards with Common 0.35% MIF	
	€m Impact MSCs	€m Impact MIF	€m Impact MSCs	€m Impact MIF
Austria	(305)	(305)	(340)	(340)
Belgium	(206)	(282)	(256)	(332)
Denmark	5	(26)	(10)	(42)
Finland	(49)	(99)	(86)	(136)
France	187	(29)	79	(137)
Germany	(1,740)	(1,855)	(2,096)	(2,211)
Greece	(206)	(206)	(235)	(235)
Ireland	(201)	(201)	(263)	(263)
Italy	(870)	(870)	(1,197)	(1,197)
Netherlands	(104)	(104)	(147)	(147)
Poland	(69)	(70)	(79)	(79)
Portugal	(1,014)	(1,051)	(1,095)	(1,131)
Spain	(1,111)	(1,359)	(1,315)	(1,563)
UK	(5,745)	(5,745)	(7,468)	(7,468)
<b>Total</b>	<b>(11,429)</b>	<b>(12,202)</b>	<b>(14,508)</b>	<b>(15,281)</b>

**Table 1.5 Five Year Impact on Credit Card MSCs of 0.5% / 0.35% Common MIF (all figures approximate)**

Credit card issuers in all countries would be impacted. On average, card issuers would have to either cut annual costs per account by between €20 (0.5% MIF) to €30 (0.35% MIF), or radically increase revenues.

The consequence would be a major set back to the credit card business across Europe. Countries with developing credit card operations would be hit hardest. Banks in new EU nations like Poland, Hungary, Czech Republic, with embryonic businesses, would find it difficult to justify continued investment.